

# IRS INTERNATIONAL TAX FORUM

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For the Tax Practitioner

Winter 1997

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## **Happy New Year!**

The new year brings with it the start of yet another filing season. Please remember that as of January 1, 1997, every return you file with us must include valid taxpayer identification numbers. So be sure to advise your clients who are not eligible to get Social Security Numbers that they will have to apply for an Individual Taxpayer Identification Number as soon as possible. IRS processing of tax returns and refunds will be delayed until a SSN or ITIN is received for each taxpayer and dependent listed. This issue of the Forum features an extensive question and answer series to help you better understand the new ITIN procedures.

Deborah Nolan was appointed as the Deputy Assistant Commissioner (International) in July. Ms Nolan began her career as an Internal Revenue Agent in California in 1972, and has held positions of increasing responsibility including the Chief, Compliance Division for Hawaii, the Chief, Examination Branch for Central California, and a senior regional analyst in the Western Region.

In 1986, Ms Nolan left federal service for fourteen months to work in a private law office in Palo Alto, California. She is licensed as a Certified Public Accountant in the State of California. Prior to assuming her current position she was the acting Assistant District Director for the IRS Rocky Mountain District. I'm sure you'll join me in welcoming her on board.

John T. Lyons  
Assistant Commissioner (International)

## Withholding on Foreign Partners

All partnerships, whether foreign or domestic, with effectively connected income allocable to its foreign partners must withhold tax on that income. Under provisions of IRC section 1446 and Revenue Procedure 89-31, the effectively connected income only needs to be **allocable** to a foreign person, not distributed. The withholding rate is 39.6 percent for individuals and 35 percent for all other entities. Withholding is reported to the IRS Philadelphia Service Center on Forms 8804, 8805 and 8813. These forms are filed separately from the Form 1065 partnership return.

The partnership is required to notify all foreign partners of their allocable shares of the section 1446 withholding paid to the IRS by the partnership. Failure to furnish correct Forms 8805 to each foreign partner may result in a \$50 penalty for each failure. A foreign partner that chooses to claim a credit against its U.S. tax for amounts withheld must attach Copy C of Form 8805 to its U.S. Income Tax Return. Civil penalties equal to the amount that should have been withheld, as well as other penalties, may be assessed for failure to withhold and pay over the tax.

Publicly traded partnerships that have effectively connected income must withhold on actual distributions to foreign partners and file Forms 1042 and 1042-S, unless they elect to withhold on the effectively connected income allocable to foreign partners.

## Answers to Commonly-Asked Questions About ITINs

### What is the purpose of an ITIN?

Individual Taxpayer Identification Numbers (ITINs) are used for account identification purposes during the processing and review of U.S. federal income tax returns. The issuance of an ITIN does not affect an individual's im-

migration status, authorization to work in the U.S., or qualify the individual for the Earned Income Tax Credit.

### Who needs an ITIN?

Anyone required to file a U.S. tax return who does not have and cannot obtain a valid social security number (SSN) must apply for an Individual Taxpayer Identification Number (ITIN). Individuals listed on a tax return as a dependent or a spouse also must obtain an ITIN if they fail to qualify for a SSN.

As of January 1, 1997, the IRS will no longer accept "SSA 205c," "applied for," "NRA," or a blank space where the SSN should be entered. Each person listed on a tax return must have a valid number — either an SSN or an ITIN. If a return requesting a refund is filed without an SSN or ITIN for the primary filer and spouse, the refund will be delayed until the taxpayers obtain valid identification numbers. If a dependent SSN/ITIN is missing, the exemption will be denied and the refunds will be adjusted accordingly. Taxpayers who have previously been assigned an IRS temporary identification number ("900-number") must now apply for an ITIN. Individuals eligible for a SSN should get one.

### Who are the most likely candidates for an ITIN?

A resident or nonresident alien who does not have and cannot get an SSN and who is:

- required to file a U.S. tax return;
- claimed as a dependent of a U.S. person on his or her U.S. tax return;
- the spouse of a U.S. person who elects to file a joint U.S. tax return;
- claimed as an exemption by a spouse on a U.S. tax return; or
- filing a U.S. tax return only to claim a refund.

### How do I apply for an ITIN?

To obtain an ITIN, the taxpayer must complete IRS Form W-7, *Application for IRS Indi-*

*vidual Taxpayer Identification Number.* The taxpayer may complete and sign a Form W-7 for a minor dependent, but other dependents and spouses must complete and sign their own Forms W-7. Documentation substantiating foreign/alien status and true identity of the individual is required. The required documentation, along with the Form W-7, may either be mailed to the Philadelphia Service Center (PSC) or presented at an IRS walk-in office.

Individual and bulk copies of Form W-7 may be ordered by calling 1-800-TAX-FORM (continental U.S. only). You may use a personal computer to download the Form W-7 from the IRS bulletin board, accessible at modem number 703-321-8020, or by accessing our World Wide Web site at <http://www.irs.ustreas.gov>. Form W-7 is generally available at IRS local offices throughout the U.S. and abroad.

**No IRS office is nearby and I'd prefer not to send my original documents by mail, is there another procedure I can use to apply?**

The IRS is developing a procedure that will enable ITIN applicants to have their documentation reviewed by locally-based "acceptance agents." Acceptance agents are individuals or entities — including certain government agencies, educational organizations, financial institutions and accounting firms — who have entered into formal agreements with the IRS. These agreements permit the agents to help applicants obtain ITINs by reviewing their documentation and forwarding the completed Form W-7 to the IRS Philadelphia Service Center for processing.

**What other options are available for applicants living abroad?**

Applicants living abroad may visit any U.S. embassy or consulate where their original documents will be examined for authenticity and notarized for a fee. However, embassy and consulate officials will not act as accep-

tance agents and will not review Forms W-7 for completeness, nor advise the applicant whether the documentation is adequate for IRS approval.

**What documentation is required for applying for an ITIN?**

All documents must be originals or certified copies from the issuing agency or custodian of the original document. For example, if an applicant's birth was registered at a local level, and the original document is now in possession of a government agency, that agency may provide a copy and certify that it is a duplicate of the original. A notary public cannot make this certification. However, the IRS is currently reviewing the status of notarization and may announce exceptions for certain forms of documentation.

Generally, the applicant will need at least two identity documents in order to validate both identity and foreign status. One of the documents should include a recent photograph. If one document — such as a passport — can validate both identity and foreign status, it will be considered acceptable.

**What are the requirements for a dependent to obtain an ITIN?**

If an adult is applying for a minor dependent, the documentation must establish the relationship between the dependent and the adult, e.g., a birth certificate or adoption papers. These documents must state that the individual claimed as a dependent is, in fact, related to the adult making the application.

The documentation must also prove that the dependent lives in the U.S., Canada, Mexico, Japan or South Korea. Examples of such documentation include: school records, doctor's records, letters from clergy, U.S. baptismal certificate, day care records, or a birth certificate that shows the dependent's relationship to the taxpayer. Proof of the current existence of the dependent individual is also required.

For dependents living in Canada, Mexico, Japan or South Korea, the documents should show the place of residence and name of the parent or guardian. Dependents living in these countries can no longer get SSNs and must apply for ITINs. They may apply for an ITIN at their nearest IRS office or at certain U.S. consular offices.

The documentation for a dependent must include:

- father's and mother's full names (mother's name at birth, not her married name).
- date and place of birth of the applicant
- applicant's full name at birth
- recent photograph (within past five years) — if child, and no photo is available, other documents, such as school or medical records, that prove where the child currently lives may be acceptable.
- signature of applicant — or if the applicant is a minor, of the legal guardian or delegate.

To be consistent with the requirement that minor children age 14 and over file their own returns to report income (even investment income), ITIN applicants age 14 and over may sign their own Forms W-7.

IRS Publication 501 contains complete details for who qualifies to be claimed as a dependent.

**What are acceptable forms of identification for ITIN applicants?**

Examples include, but are not limited to:

- Passport
- Foreign voter registration card if a photo is included
- Foreign military identification card
- U.S. visa (border crossing card — Canada & Mexico only)
- INS documents I-94, I-20 ID, I-95A, I-184, I-185, I-186, I-444, I-586

- National Identity Card
- Baptismal certificate
- Marriage certificate
- Driver's license or State I.D.
- Birth certificate
- School documents

**How long does it take to get an ITIN?**

Generally, it takes about six weeks from the time you apply until you receive the ITIN, so taxpayers should submit their application several months before the tax return is due. Depending on the local mail system, applications mailed from abroad may take considerably longer than those submitted from within the U.S. Taxpayers may call the IRS Philadelphia Service Center on (215) 516-4846 to check on the status of their application if receipt of the Form W-7 has not been acknowledged after 14 days.

Form W-7 should not be filed with the taxpayer's Form 1040. Failure to timely apply for all the needed ITINs will not be considered a valid excuse for late filing of a tax return.

**If a refund is delayed because an inappropriate TIN was used, can an ITIN be applied for and used to release the refund?**

Yes. The IRS Service Center in Philadelphia will process the Form W-7 and issue the ITIN. Taxpayers may, however, bring their applications, with supporting documentation, to an IRS walk-in office or have them sent to the Service Center via an Acceptance Agent when the procedures are approved. Once the ITINs are associated with the tax return the refunds can be issued.

**Which aliens are eligible to receive SSNs?**

Certain foreign nationals by virtue of their status are authorized to work in the U.S. with no restrictions as to the location or type of employment. Although they have the right to work, some must apply to the Immigration and Naturalization Service (INS) for an Employment Authorization Document (EAD).

Any nonresident alien holding an EAD is eligible to get a SSN.

**What can I use to show the IRS that Social Security will not provide me with an SSN?**

A copy of SSA's letter indicating that you are not eligible to receive an SSN. This is available only upon request to the SSA and is not required as part of the ITIN application process.

**Can an undocumented alien obtain an ITIN?**

Yes, if needed to fulfill a U.S. federal income tax obligation and with acceptable documentation. The undocumented alien need only provide proof of identity and a U.S. address to qualify.

**Under what circumstances would the IRS deny an ITIN to someone who also cannot get an SSN?**

When the individual cannot satisfactorily provide documentation to validate his or her identity or foreign status.

**What should an employer do when a job applicant tries to use an ITIN for employment?**

The employer should advise the applicant that the ITIN is not a valid ID number for work purposes and that he should contact SSA to get an SSN if he is legally entitled to work in the U.S. If the employee cannot get an SSN, the ITIN should be used for IRS reporting purposes.

**Does filing a form W-8 with a bank relieve the nonresident alien from getting an ITIN?**

No. If a return must be filed to report income from U.S. sources other than bank interest, or if the interest received from the bank account is effectively connected with a U.S. trade or business, an ITIN is still required.

**Should a bank accept a Form W-8 that does not include an ITIN?**

Yes. However, currently proposed regulations under Internal Revenue Code section 1441 will encourage the use of the ITIN in banking situations since the Form W-8 will

be valid indefinitely (or until circumstances or status changes requiring a new Form W-8) when it is submitted with an ITIN. It will not have to be renewed every three years. Banks paying U.S. income other than portfolio interest and dividends on publicly traded stock will require an ITIN on Form W-8 in order to obtain reduced tax treaty withholding rates. Please note, however, that these proposed regulations are not yet effective.

**Will an ITIN be required for claiming tax treaty benefits?**

Currently, an individual claiming a tax treaty benefit must be a tax resident of the country whose treaty benefit is being claimed and must provide the withholding agent a Form 1001 (this form currently does not require a tax identification number). Proposed regulations under IRC section 1441 would require an individual to provide the withholding agent a Form W-8 with an ITIN to receive the treaty benefit, except in the case of dividends on publicly traded stock.

## Expatriation Tax

Expatriation tax provisions apply to U.S. citizens who have renounced their citizenship and long-term residents who have ended their residency, if one of the principal purposes of the action is the avoidance of U.S. taxes.

For 1996, you are presumed to have tax avoidance as a principal purpose if:

- Your average annual net income tax for the last five tax years ending before the date of the action is \$500,000 or more, or
- Your net worth on the date of the action is \$500,000 or more.

A long-term resident is defined as a person who was a lawful permanent resident of the U.S. in at least 8 of the last 15 tax years ending with the year such residency ended. In determining if a person met the 8-year re-

quirement, do not count any year that the individual was treated as a resident of a foreign country under a tax treaty and did not waive treaty benefits.

U.S. residency is considered to have ended when the individual ceases to be a lawful permanent resident or commences to be treated as a resident of a foreign country under a tax treaty and does not waive treaty benefits.

Individuals covered by these rules are subject to tax on U.S. source income and gains at the graduated rates applicable to U.S. citizens (if it is more than the tax computed under the rules for nonresident aliens). This applies to the 10-year period following the date of the action.

Generally, the provisions relating to long-term residents and the presumption of tax avoidance apply to actions that occur after February 5, 1995. For more information on the expatriation tax provisions, including exceptions to the tax and special U.S. source rules, see IRC section 877 and Notice 96-60, which appeared in Internal Revenue Bulletin 1996-49, dated December 2, 1996.

Individuals who intend to renounce their citizenship are subject to new reporting requirements and must complete a form that will be provided by the Department of State (or other designated government entity) prior to renouncing citizenship. If the form is not available, a statement must be provided that includes the individual's name, address, taxpayer identification number, current mailing address, address of current residence (if different than mailing address), mailing address of principal foreign address (if any), address where the individual expects to reside after losing U.S. citizenship (if different than principal foreign address listed above), the countries where the individual holds citizenship and the date(s) such citizenship was acquired, and the number of days that the individual was physically present in the U.S. for the current taxable year and the two pre-

ceding taxable years (including vacation and nonwork days).

Long-term residents who are terminating residency are required to complete a form that will be provided by the Immigration and Naturalization Service or the IRS. They must return this form with their tax return for the year that their residency ends. If the form is not available, they must provide a statement with their tax return for that year that include the information described above.

## **Misuse of Foreign Trusts Draws IRS Attention**

You've seen the ads in newspapers, magazines and on the Internet. They offer to help you set up a foreign trust that, according to promoters, will substantially reduce your income taxes, while eliminating estate, gift and excise tax liabilities. Some of them even boast that nobody will know the trust exists.

The IRS wants to set the record straight and help you and your clients avoid the pitfalls of these types of promotions. Foreign trusts with U.S. beneficiaries funded or created by a U.S. person are fully subject to Federal income tax. The assets transferred to the trust by the grantor are deemed to be constructively owned by the grantor. Thus, the income from the trust attributable to those assets is taxable to the grantor.

Because the grantor picks up all the income and is considered to constructively own the assets, when a distribution is made to a beneficiary there is a potential gift tax liability. It's the same as if the distribution, transfer or gift was made directly to the recipient. In a similar manner the U.S. grantor may also be subject to estate taxes on the value of the assets in the foreign trust.

There are a few limited exceptions to the income tax rules. For example, when a U.S. person transfers assets to an irrevocable foreign trust that cannot be amended and can

never have a U.S. beneficiary, the U.S. person will not be considered to be the owner of the asset for income tax purposes. There will be no continuing income tax liability. However, there may be gift tax and excise tax on the transfer.

New legislation, passed in August 1996, changes the definition of a foreign trust and the filing requirements for transfers to, income attributable to, or distributions from a foreign trust. Beginning in 1997, a trust is a foreign trust if either: (1) a court within the United States is able to exercise primary supervision over the administration of the trust, or, (2) one or more U.S. fiduciaries (trustees) have the authority to control all subsequent decisions of the trust. Substantial penalties (35 percent of the reportable income in most cases) apply for failure to comply with these new filing requirements. For further information, please review the instructions to Form 3520, *Annual Return to Report Transactions with Foreign Trusts and Receipt of Foreign Gifts*, which should be available before the end of 1997. When available, this form may be downloaded from the IRS "home page" on the Internet.

## Errors on Form 5471 Delay Processing

Form 5471, *Information Return of U.S. Persons With Respect to Certain Foreign Corporations*, is used by U.S. citizens and residents who are officers, directors, or shareholders in certain foreign corporations. This form satisfies the reporting requirements of IRC sections 6035, 6038, 6046, and the related regulations.

The IRS has noted that some filers of Form 5471 report a second tier corporation in space provided for entering the "name of person filing this return," when, in fact, the second tier corporation actually files a consolidated return with the parent corporation. This is not correct. Please follow the instructions for Form 5471 (page 4 under "Item A") which state: "If a U.S. corporation is a mem-

ber of a consolidated group, list the common parent as the person filing the return and enter its EIN in Item A. Identify the direct owner in Item D."

## Closer Connection Statements to be Retained by PSC

An individual who met the "substantial presence test," but is present in the U.S. for fewer than 183 days during the current year, will not be treated as a resident if he or she has a tax home in a foreign country and a closer connection to that foreign country than with the United States. Taxpayers who qualify for this exception may elect to claim it by filing Form 8840 with the IRS Philadelphia Service Center (PSC).

Until last year the PSC had been returning the Forms 8840 to the filer after stamping them as "certified received." Beginning with the 1996 tax year, however, these forms will be kept on file at the PSC rather than being returned to the filer.

For further details on qualifying for and claiming a "closer connection" exception, please review Publication 519, *Tax Guide for Aliens*.

## Video Help Available for Students and Scholars

The Office of International District Operations has produced a videotape entitled "Tax Tips—The Scholarship Edition" (1996). It is designed for use by U.S. citizens and resident aliens who study, teach or conduct research abroad and focuses on the taxability of scholarships and fellowship grants. The video is expected to be available in February 1997. For more information, contact your nearest IRS overseas post of duty. Within the U.S., check with the Public Affairs Office, Office of the Assistant Commissioner (International) in Washington, D.C. The telephone number is 202/874-1758.

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## TAX FORUM

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